

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:MCT:WAS:RCH:TL-N-2266-01  
CMDRees

date: **JUN 04 2001**

to: Team Manager Ken Hewett, Wheaton, Maryland

from: CHERYL M.D. REES  
Senior Attorney (LMSB)

subject:

Accumulated Earnings Tax

This is in response to the request for advice you forwarded to us on April 10, 2001 and supplemented with facts on April 20, 2001.

**ISSUES**

1. Whether the accumulated earnings tax can apply to the taxpayer even though its only direct shareholders are corporations, two of which are foreign corporations.

2. Whether the taxpayer unreasonably accumulated its earnings and profits in [REDACTED], [REDACTED] and [REDACTED].

3. Whether, during [REDACTED], [REDACTED] and [REDACTED], the taxpayer was formed or availed of for the purpose of avoiding income taxes with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to be accumulated instead of being divided or distributed, and is, therefore, subject to the accumulated earnings tax imposed by I.R.C. § 531.

**CONCLUSIONS**

1. It is possible for the accumulated earnings tax to apply to a corporation even though its only direct shareholders are corporations, two of which are foreign corporations.

2. Although this is a question of fact, it is our opinion that there is evidence that the taxpayer unreasonably accumulated its earnings and profits during the years at issue.

3. It is our opinion that, under the facts forwarded to our office, the taxpayer was not formed or availed of for the purpose of avoiding income taxes with respect to its shareholders or the

shareholders of another corporation during the years at issue herein. Nonetheless, further factual clarification or development may demonstrate otherwise.

#### FACTS

[redacted] [hereinafter referred to as [redacted]] was a United States corporation that was formed in [redacted] under the laws of [redacted]. It derived its revenue primarily from mutual funds sponsored by [redacted] and institutional private account investors primarily domiciled in the United States. Its officers were located in [redacted], but it had offices in [redacted], [redacted], [redacted], [redacted], [redacted] and [redacted]. During the years at issue herein, it was owned by the following corporations:

#### Corporation

#### Percentage Ownership

[redacted]	[redacted] %
[redacted]	[redacted] %
( [redacted] )	[redacted] %
[redacted] ( [redacted] )	[redacted] %

[redacted] was a wholly-owned subsidiary of [redacted], a United States corporation located in [redacted] which was publically held. [redacted] was a wholly-owned subsidiary of [redacted], a United Kingdom corporation. [redacted] was [redacted] owned by the [redacted], a Hong Kong corporation. [redacted] percent of the [redacted] was owned by [redacted] and the remaining [redacted] % was owned by [redacted]. A copy of an organizational chart of direct and indirect ownership of [redacted] is attached hereto as Exhibit A. [redacted] was publicly traded. [redacted] filed a consolidated return with [redacted] during the years at issue.

[redacted] had the right to elect the majority of the Board of Directors of [redacted]. We do not know who was on the Board of Directors or whether they were liable for individual income taxes in the United States.

[redacted] had a long-standing policy of distributing all earnings to its shareholders, except to the extent of funds required to be retained by the Investment Management Regulatory Organization [IMRO]. The IMRO is a British Regulatory Agency similar to the SEC that required [redacted] to file an Annual Financial Return certifying that it had complied with the IMRO rules. One such rule was that [redacted] must maintain a specified amount of financial

resources. [REDACTED] reconfirmed its policy at the meeting of its Board of Directors on [REDACTED]. At the meeting, the Directors reiterated the company's policy of paying out in full its earnings in the form of dividend, subject only to the capital requirements of Investment Management Regulatory Organization (IMRO).

The From [REDACTED] through [REDACTED], the taxpayer made the following dividend payments:

Year	Book Net Income after taxes	Dividend declared during year based on retained earnings through prior year end	Percent of dividend to prior year retained earnings or net income
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	[REDACTED]
TOTAL	[REDACTED]	[REDACTED]	[REDACTED]

The Service audited [REDACTED]'s [REDACTED] and [REDACTED] taxable years and determined that, pursuant to I.R.C. § 1442, it did not withhold enough tax on the dividends that it paid to its two foreign shareholders. On its original returns, [REDACTED] took the position that I.R.C. § 1442 did not apply and withheld far less than [REDACTED] % of the dividends that it paid to [REDACTED] and [REDACTED] during [REDACTED] and [REDACTED]. On [REDACTED], the Service sent [REDACTED] an information document request that first requested documents relating to the withholding issue. When the international examiner first met with representative's of [REDACTED] in [REDACTED] of [REDACTED], he asked the representatives additional questions regarding the withholding issue.

The Service determined that [REDACTED] % of the dividends paid by [REDACTED] were subject to withholding. The total potential withholding tax liability due from the taxpayer for its [REDACTED] and [REDACTED] taxable years, as originally proposed by the Service, is as follows:

Year	Proposed Withholding Tax	Estimated Interest at [REDACTED] %/Year to Year [REDACTED]	Total Potentially Due IRS
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
TOTAL	[REDACTED]	[REDACTED]	[REDACTED]

The Service issued a Notice of Proposed Adjustment asserting the maximum withholding liability on [REDACTED]. The Service and [REDACTED] did not agree to the proposed liability and, in July of [REDACTED], the Service issued a 30-day letter to the taxpayer. The taxpayer then protested the issue to Appeals. [REDACTED] reached a tentative agreement with Appeals in [REDACTED] that was finalized in [REDACTED] of [REDACTED]. The agreement reduced [REDACTED]'s withholding tax due to \$ [REDACTED] and \$ [REDACTED] for its [REDACTED] and [REDACTED] taxable years, respectively. It also set a formula for computing [REDACTED]'s withholding tax liability in subsequent years.

In our Revenue Agent's Report regarding the accumulated earnings tax for [REDACTED]'s [REDACTED] and [REDACTED] taxable years we have stated that, "Since [REDACTED] could not resolve the issue with the examination team, it decided to forego the dividend payment to prevent the team from again raising the issue in calendar year [REDACTED]."

As we mentioned above, [REDACTED] was required to file an Annual Financial Return with IMRO, the British regulatory agency, certifying that it had complied with the IMRO rules. According to returns filed with IMRO by [REDACTED], it was required by IMRO to maintain the following financial resources:

For the year ended [REDACTED]: \$ [REDACTED] (Per return filed in [REDACTED])  
 For the year ended [REDACTED]: [REDACTED] (Per return filed in [REDACTED])  
 For the year ended [REDACTED]: [REDACTED] (Per return filed in [REDACTED])  
 For the year ended [REDACTED]: [REDACTED] (Per return filed in [REDACTED])

The following table shows the retained earnings [R.E.] balances, and related information for [REDACTED]'s taxable years [REDACTED] through [REDACTED]:

Year	Beginning Retained Earnings	Plus: Net Book Income After Tax	Retained Earnings Balance Prior to Distribution	Less: Dividend Distribution Made at the Beginning of the Subsequent year	Retained Earnings Balance After Distribution	Percent of Dividends to Net Income
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	(\$ [REDACTED])	\$ [REDACTED]	%
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	(\$ [REDACTED])	\$ [REDACTED]	%
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	(\$ [REDACTED])	\$ [REDACTED]	%
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	(\$ [REDACTED])	\$ [REDACTED]	%
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	(\$ [REDACTED])	\$ [REDACTED]	%

The percentages of dividends to the total accumulated earnings, however, were only as follows:

Year                      Percentage

[REDACTED]	%
[REDACTED]	%
[REDACTED]	%
[REDACTED]	%
[REDACTED]	%

The following table shows the Balance Sheet and Current Ratio figures for [REDACTED] during the years at issue:

Cash & Cash Equivalent  
Account Receivable

[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Investments in Mutual Funds				
Investments in				
International Partners				
Total Current Assets				
Other Assets				
Total Assets				
Accounts payable				
Income Taxes Payable				
Total Current Liabilities				
Common Stock &				
Paid-in Capital				
Unrealized Security				
Holding Gain				
Retained Earnings				
Total Equities				
Total Liabilities & Equities				
Current Ratio				
(Current Asset over Current Liab.)				

It is interesting to note that's cash balance increased approximately five-fold from through. Its Current Assets grew nearly three-fold during the years at issue herein and its Retained Earnings tripled.

did not own any buildings or equipment. It used the facilities, equipment and personnel of its shareholders to run its daily operations and reimbursed them for their costs. did not have any lease obligations, nor did it have a capital budget. The minutes of the meetings of its Board of Directors indicated that the board never discussed or considered any expansion plan that required any material amount of capital.

From through the Service sent requests for additional information to and a Notice of Proposed Adjustment. We do not know whether the Notice of Proposed Adjustment met the requirements of I.R.C. § 533(b). responded by letter dated. It set forth its position that the accumulated earnings tax did not apply to it because:

1. Since its shareholders are not subject to United States individual income tax, the accumulated earnings tax did not apply as a matter of law.

2. had a history of paying significant dividends and all earnings not distributed to shareholders were reasonable in view of the business needs of the company.

3. The Notice of Proposed Adjustment contained numerous errors of fact and drew unsupported legal conclusions.

The reasonable business needs the taxpayer discussed in its letter were the need to cover potential liabilities for withholding taxes for its [REDACTED] and [REDACTED] taxable years and special requirements of the industry. It also made cursory mention of the needs to accumulate funds to finance potential acquisitions, including the [REDACTED]% of its shares owned by the foreign corporations. It reserved the right to "explore such needs in the future". Finally, in part three of its letter, it mentioned that it would be appropriate to look at the reasonable business needs of [REDACTED] and [REDACTED] as well as its own. It did not elaborate on any such needs.

#### ANALYSIS

##### ISSUE 1

As noted above, [REDACTED] argues that, as a matter of law, the accumulated earnings tax does not apply to it because its three shareholders are corporations and not subject to United States individual income tax. They may have been lulled into thinking that we would find the argument persuasive by virtue of the fact that, in the Notice of Proposed Adjustment dated [REDACTED], the Service set forth a computation of taxes saved by the taxpayer by accumulating its earnings and included only corporate income taxes avoided by [REDACTED] and withholding tax avoided by [REDACTED] on account of dividends that were not paid to [REDACTED] and [REDACTED]. The Service did not go on to compute the U.S. individual income tax that was avoided by indirect shareholders of [REDACTED] through [REDACTED], a U.S. publicly held corporation. It is unlikely that the Service possesses the information necessary to make such computations at this time.

While we all agree with [REDACTED] that the avoidance the accumulated earnings tax seeks to remedy is U.S. individual income tax, we do not agree that only direct shareholders are considered. I.R.C. § 532(a) provides that the accumulated earnings tax imposed by I.R.C. § 531 applies to every corporation, except those listed in I.R.C. § 532(b) and not relevant here, "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders, or the shareholders of other corporations, by permitting earnings and profits to accumulate instead of being divided or distributed." I.R.C. § 532(a) (emphasis added). Treasury Regulation § 1.532-1(a) amplifies the Code by adding that the accumulated earnings

tax applies to any domestic or foreign corporation formed or availed of to avoid or prevent the imposition of individual income tax on its shareholders or the shareholders of other corporations. Furthermore, the accumulated earnings tax may apply to a publicly held corporation even where the management group was less than 50%. See I.R.C. § 532(c); H. Conf. Report 98-861, at 828 (1984), 1984-3 C.B. 1, 82; Technalysis Corporation v. Commissioner, 101 T.C. 397, 403-406 (1993) ("Theoretically . . . it is not necessary that those who are responsible for the existence of the accumulation and proscribed purpose (officers and/or directors) also be shareholders.")

The question of whether the accumulation was done with the intent to avoid income taxes is one of fact. Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 583 (1965). The problem that arises when the only shareholders that might avoid U.S. individual income tax are indirect and we are dealing with a publicly held corporation is that proof of a corporate intent to avoid individual income tax becomes tangential and more difficult. As the Tax Court noted in Technalysis Corporation v. Commissioner, 101 T.C. 397 (1993), it is possible to draw the inference that the dilution of ownership of a corporation diminishes the potential benefits from an accumulation of profits to a point where it becomes de minimis. It also noted that the fact that a corporation is widely held may be considered on a case-by-case basis in determining whether the purpose of avoidance exists. Id. at fn 2 and pp. 405-06.

Thus, in a case in which shareholders liable for individual income taxes are indirect shareholders and the parent corporation they own is widely held, we must take even more care than usual to bolster circumstantial evidence of the prohibited intent. We know that, under both the Appeals settlement of the withholding issue and Examination's position, \$[REDACTED] was shielded from the corporate income taxes due from [REDACTED] by the accumulation of earnings in the [REDACTED] years at issue. We also know, from [REDACTED], that no U.S. individual income tax would have ever been paid on one-half of all dividends that might have been paid. Without more, this creates some confusion or doubt as to whether the corporation's accumulation was motivated by improper avoidance of U.S. individual income tax.

We could bolster our position by developing additional facts. For example, it would be interesting to know who is on the Board of Directors of [REDACTED] and whether they pay U.S. individual income tax. It would also be helpful to know how much of the dividends we believe should have been paid to [REDACTED] [REDACTED] would have reached through the hands of [REDACTED] to individual U.S. shareholders and to know the control percentages



of U.S. shareholders in [REDACTED].

[REDACTED]'s position that the provisions of I.R.C. § 531 do not apply to it as a matter of law is incorrect. Nonetheless, without additional factual development, our position is weakened by this element of the factual inquiry.

## ISSUE 2

The United States Supreme Court and the Tax Court have observed that the most important factor in deciding if the accumulated earnings tax applies is whether a corporation accumulates earnings and profits in excess of the reasonable needs of the business. See United States v. Donruss Co., 393 U.S. 297, 307 (1969); Technalysis Corporation v. Commissioner, 101 T.C. 397, 403 (1993). In demonstrating that its retention of current earnings and profits is reasonable, a corporation needs to be careful to avoid the circumstance where its prior accumulations are more than adequate to cover the reasonable needs it demonstrates. See, Cheyenne Newspapers, Inc. v. Commissioner, T.C. Memo 1973-52.

At the end of [REDACTED], [REDACTED] had \$[REDACTED] in accumulated earnings. This sum increased to \$[REDACTED] by the end of [REDACTED]. At the end of [REDACTED] there was another increase in the balance of the accumulated earnings to a balance of \$[REDACTED]. Finally, by the end of [REDACTED], there were total accumulated earnings of \$[REDACTED]. According to [REDACTED]'s balance sheet's these sums were exceeded by the amount of cash and cash equivalent held by the corporation for [REDACTED] and [REDACTED]. According to our computations, [REDACTED] had the following amounts of cash available for distribution of dividends, after allowing it reserves for the financial resources required by IMRO, in the following amounts:

<u>Year</u>	<u>Available For Distribution as Dividends</u>
[REDACTED]	\$[REDACTED]

We will discuss each of the business needs that may apply in the taxpayer's situation.

## IMRO Financial Resources Requirements

We know that the corporation was required to keep certain levels of financial resources on hand in each of the years [REDACTED], [REDACTED] and [REDACTED] by the IMRO. We agree that these sums fall within

the reasonably anticipated needs of the corporation and allowed them to [REDACTED] when we calculated the accumulated earnings tax. [REDACTED] at [REDACTED] + [REDACTED] at [REDACTED]; + [REDACTED] at [REDACTED] + [REDACTED] at [REDACTED].] It might be helpful to know details regarding the IMRO requirements. For example, the factual analysis of reasonable business needs would change depending upon whether the IMRO requires retention of 100% of predictable business needs or requires retention of only 10% of such needs.

*Contingent Liability Presented by [REDACTED]'s Withholding Tax Controversy with the Service.*

In the RAR we stated that the maximum withholding tax at issue for [REDACTED]'s [REDACTED] and [REDACTED] taxable years was \$ [REDACTED] and \$ [REDACTED], respectively ( $\$ [REDACTED] + \$ [REDACTED] = \$ [REDACTED]$ ). Furthermore, interest on those amounts at [REDACTED] % per year to [REDACTED] totaled \$ [REDACTED]. Together, the tax and interest totaled \$ [REDACTED]. Because the dividends had already been paid by the end of [REDACTED], it was possible to compute the maximum withholding tax liability the corporation faced prior to the end of [REDACTED]. The question remains whether it was reasonable for [REDACTED] to assume that it would ultimately pay the maximum and to decide whether it was reasonable to assume that they would pay interest and make no payments until [REDACTED].<sup>1</sup>

Treasury Regulation § 1.537-1 adopts a reasonable businessman standard for evaluating whether the alleged business needs of a taxpayer are reasonable. See Treas. Reg. § 1.537-1; Knight Furniture Co., Inc. v. Commissioner, T.C. Memo. 2001-19. Courts have shown great deference to the decisions of boards of directors unless the facts and circumstances clearly demonstrate that the accumulations of earnings and profits were unreasonable. Technalysis Corporation v. Commissioner, 101 T.C. 397, 411 (1993); Snow Manufacturing Co. v. Commissioner, 86 T.C. 260, 269 (1986); Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 583 (1965); Knight Furniture Co., Inc. v. Commissioner, T.C. Memo. 2001-19.

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<sup>1</sup> We do not have copies of transcripts so we can not tell whether [REDACTED] made advanced payments toward the liability to stop the running of interest. If it did, the accrual of interest may have stopped. Furthermore, in its letter dated [REDACTED], at page 4, it indicated that initial indications were that its dispute with the Service would be resolved quickly. This makes retention of sums to pay interest computed to the year [REDACTED] appear unreasonable.

The Tax Court and the Fourth Circuit Court of Appeals, which presides over the circuit in which we sit, have determined that contingencies are reasonable needs for which businesses may provide. The contingency must be likely, not merely remotely possible, in order to qualify. See, Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 583 (1965); Smoot Sand and Gravel Corp. v. Commissioner, 241 F.2d 197, 206 (4<sup>th</sup> Cir. 1957), cert. denied, 354 U.S. 922 (1957).

We do not have sufficient information from the administrative files relating to the examination of the taxpayer's [REDACTED] and [REDACTED] tax years to determine the amount it would have been reasonable for [REDACTED] to accumulate for this purpose. We do know that it would have been unreasonable for it to retain more than the maximum liability possible, plus interest thereon. For the sake of discussion, let's assume that it would have been reasonable for [REDACTED] to accumulate enough of its retained earnings to cover the entire amount computed by the Service as the most possible: \$[REDACTED]. It seems likely that [REDACTED] was entitled to retain earnings in regard to the contingent liability from the end of [REDACTED] on. The amount at any given time is dependent upon the facts surrounding the negotiations between the taxpayer and either the field or appeals. In the light most favorable to the taxpayer, it would have been reasonable for it to retain \$[REDACTED] beginning in [REDACTED]. No additional sums would have needed to have been added in [REDACTED], [REDACTED] or [REDACTED].

Even if this sum, which is most favorable to the taxpayer, is added to the sums we allowed for the IMRO requirements, it appears that the earnings the corporation accumulated prior to the beginning of [REDACTED] would have been adequate to meet both needs.

#### *History of Paying Significant Dividends*

[REDACTED] alleged in its response that its dividend record compared to its peers and competitors was generous and, therefore, should not be considered inadequate. To substantiate its assertion, it provided comparisons between the total equity of various companies divided by the accounts under management of each. It did not detail how it compared with each company in terms of reasonable business needs or how the resulting percentages related to dividends. Furthermore, the chart appears to have been prepared by, or on behalf of, the taxpayer and we do not know the foundation of the numbers from which it draws its statistics. The chart that sets forth corporate dividend comparison's is more germane but would be more helpful if we knew how each company otherwise compared to [REDACTED].

In fact, [REDACTED]'s history of paying dividends is more likely to work against it. From [REDACTED], when it began to distribute dividends, it averaged dividends of [REDACTED] % of its net income in each prior year. It paid as much as [REDACTED] % of its net income for the prior year in dividends in one year. According to its own computations, in several years it paid more in dividends than its entire previous accumulated earnings. Thus, it demonstrated its ability to pay its business expenses from current income. Yet, in the years at issue, it averaged dividends of only [REDACTED] % of its net book income for the prior years. And, after paying out only [REDACTED] % of its total accumulated earnings in early [REDACTED], it paid out [REDACTED] in [REDACTED], [REDACTED] % of its total accumulated earnings in [REDACTED] and [REDACTED] % in [REDACTED].

As a result, its cash balance increased approximately five-fold, its current assets grew nearly three-fold and its retained earnings tripled during the years at issue. All of this despite the fact that, outside of its withholding controversy with the Service, [REDACTED] has not cited any unusual or unusually costly reasonable business needs during the years at issue.

#### *Special Requirements of the Industry*

This is another area for which it would be useful to know details about the IMRO requirements. How do their financial resources requirements relate, if at all, to needs of the industry? On pages 6 and 7 of its letter dated [REDACTED], [REDACTED] asserted that, in its business, it is "extremely important to maintain a strong balance sheet." In part, it explained, this was needed to retain investor confidence and, in other part, to be able to withstand "severe financial needs." It also suggested that use of a Bardahl calculation would not be appropriate to determine its working capital needs but did not suggest just what its needs were or how they might be computed.

The taxpayer failed to offer the amount of resources it would have needed in the years at issue to encourage investor confidence or hint at why it would have had to so dramatically reduce its dividend-payment pattern to do so in the years at issue. Likewise, though it referred generally to a problem [REDACTED] faced in the [REDACTED]'s, it did not specify any reasonable needs it faced during the years at issue to retain funds to allow it to withstand severe financial needs. Once again, it did not explain why this was a more critical need during the years at issue or how much of its retained earnings were related to this alleged justification.

### *Future Potential Acquisitions*

█████ summarily stated that it reserved the right to explore its need to accumulate funds to finance potential acquisitions, including to acquire the █████ % of its shares owned by others than █████ through █████. Without specifics, it is difficult to agree that they had reasonable business needs in this regard.

As a general rule, future acquisitions and expansion may justify the retention of earnings. The Courts have most often looked for definite plans for such expenditures before allowing them to qualify as reasonable business needs. See Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 584-85 (1965). However, as the Tax Court found in Technalysis Corporation v. Commissioner, 101 T.C. 397 (1993), "[s]pecificity and definiteness, coupled with action toward achieving the claimed purpose, are essential in finding the accumulation reasonable." Id. at 409, citing Dixie, Inc. v. Commissioner, 277 F.2d 526, 528 (2d Cir. 1960), aff'ing 31 T.C. 415 (1958).

### *Available Cash and Short-term Cash Needs*

Historically, █████ has demonstrated its ability to meet its short-term cash needs from annual earnings. It has presented no estimate of any reasonable needs it faced in the years at issue.

### *Concern Over Future Withholding Liability*

The arguments █████ set forth in its letter dated █████ regarding its desire to forego paying dividends because it was uncertain how much its withholding liability would be on dividends paid goes more to its motivation than to its reasonable business needs. This is because its withholding liability would have been paid from the dividends themselves rather than from a separate reserve set up for the purpose of paying the liability.

In sum, the facts and circumstances surrounding a taxpayer's reasonable business needs are generally within its own knowledge. █████ has not shared and supported specific sums it needed during the years at issue beyond the sums needed to meet its contingent liability for withholding taxes for its █████ and █████ taxable years and the sums required by IMRO. In fact, reference to the minutes of its board of directors meetings and its history of dividend payment work against its assertion that its accumulations were warranted by reasonable business need. Thus, at this point in time, it is our opinion that we have a strong position that the accumulations were unreasonable.

ISSUE 3

The accumulated earnings tax is imposed on the corporation's "accumulated taxable income." I.R.C. § 531. Section 535 defines that term as the corporation's taxable income adjusted for certain items including a credit for an amount equal to the part of its earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus some specified sums. I.R.C. § 535(a) and (c). I.R.C. § 537(a) sets for the general rule that the term, "reasonable needs of the business," includes:

1. the reasonably anticipated needs of the business;
2. the section 303 redemption needs of the business;
- and,
3. the excess business holdings redemption needs of the business.

I.R.C. § 537(a). Items 2. and 3. are not applicable here.

The tax does not apply, however, unless the corporation accumulated earnings and profits in order to avoid individual income tax with respect to its shareholders or shareholders of another corporation. I.R.C. § 532(a). Avoiding individual income tax does not have to be the corporation's only, or even its primary, motive. United States v. Donruss Co., 393 U.S. 297 (1969); Industrial Life Insurance Co. v. United States, 344 F. Supp. 870, 878 (D.C. S.C. 1972), aff'd, 481 F.2d 609 (4<sup>th</sup> Cir. 1973); Eyefull, Inc. v. Commissioner, T.C. Memo. 1996-238. Nonetheless, the prohibited intent must be present. Technalysis Corporation v. Commissioner, 101 T.C. 397 (1993); Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 584-85 (1965).

I.R.C. § 533(a) establishes the presumption that a corporation that accumulates earnings and profits beyond its reasonable needs does so with the purpose of avoiding income tax with respect to its shareholder. The presumption, however, can be rebutted by the corporation if there is a preponderance of evidence that it did not have the prohibited purpose. See, Technalysis Corporation v. Commissioner, 101 T.C. 397, 403 (1993); Snow Manufacturing Co. v. Commissioner, 86 T.C. 260, 269 (1986). Courts have found that, even though a taxpayer accumulated earnings and profits beyond its reasonable business needs, it did not have the prohibited intent. See, Technalysis Corporation v. Commissioner, 101 T.C. 397 (1993); Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 584-85 (1965). See also, Treas. Reg. § 1.533-1(a)(2).

It is our opinion that this may be one of the unusual cases

in which there appear to be an unreasonable accumulation but no prohibited intent. First and foremost, if we truly believe that [REDACTED]'s reason for foregoing dividends in [REDACTED] and [REDACTED] was to avoid its withholding tax liability, it would not be appropriate to assert the accumulated earnings tax against them. Although avoiding withholding tax liability is not laudable, it is not the type of tax avoidance Congress sought to remedy or to deter through imposition of the accumulated earnings tax. If we do not believe that [REDACTED] was motivated by its withholding tax liability to forego dividends, we should reword the RAR to clarify that point.

Although [REDACTED] now denies stating that it decided not to pay dividends in the years at issue to avoid withholding taxes, it does assert that confusion over the amount of withholding tax that would be due on dividends and its belief that the examination of its [REDACTED] and [REDACTED] withholding tax liabilities would be resolved quickly caused it to forego dividends in [REDACTED] and to pay limited dividends in the following [REDACTED] years. It also states that its shareholders were pressuring it to make dividend payments and that, in the years at issue, it made the Service aware that it desired to resolve the examination quickly and resume distributions (p. 4 of its letter dated [REDACTED]). If [REDACTED] could prove these statements through documents or testimony, it is unlikely that a Court would find that they had the requisite prohibited intent in accumulating earnings and profits.

As we discussed under Issue 1, the taxpayer's task of rebutting the presumption that its accumulation of earnings and profits beyond its reasonable needs was done so for the purpose of avoiding individual income tax is made easier due to the fact that it had only corporate shareholders. The only shareholders that stood to avoid individual income tax were shareholders of [REDACTED], a publicly held corporation.

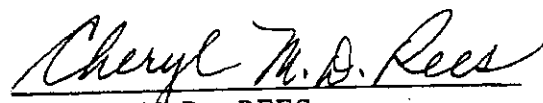
Additional risks to the Service's position are that we have found no evidence of loans to shareholders, no expenditures by the corporation for the personal benefit of the shareholders, no investments in unrelated businesses and there was a strong history of paying dividends. The Tax Court has found that these factors are "strong indications that the accumulations were not for the proscribed purpose." Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566, 588 (1965). See also, Treas. Reg. § 1.533-1(a)(2).

Thus, if we do not believe that [REDACTED] avoided paying dividends to avoid payment of withholding taxes and, instead, sought to avoid payment of individual income taxes, it would be

best to develop additional facts in support of our position.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Because this is an unusual fact pattern, we are sending a copy of this memorandum to the National Office for post review. Therefore, please do not take action on our advice until we learn the results of that review. If you have questions or if we may be of additional assistance, please contact me at (804) 916-3947.



CHERYL M.D. REES  
Senior Attorney (LMSB)